26

INTER-GOVERNMENTAL FISCAL RELATIONS

FOCUS QUESTIONS

1. How are the responsibilities for providing public goods and services shared between the federal government and the states?
2. What are the economic principles that ought to govern the assignment of responsibilities? When can there be efficient decentralization of decision making concerning the provision and financing of public services?
3. What role should the federal government undertake in redistributing income from rich states to poor states? How does the federal government subsidize states now, and how effective are these subsidies?

The Constitution of the United States stipulates that powers not expressly delegated to the federal government (e.g., providing for the national defense, printing money, and running the post office) rest with the states. For a long time, the prevailing view was that this seems to leave responsibility for the provision of most public services (e.g., education, police and fire protection, and roads and highways) with the states. The Constitution is a flexible document, however, and court interpretations of it have essentially freed the federal government to provide many other services.

There has been an ongoing debate about **fiscal federalism**, the division of economic responsibilities between the federal government and the states and localities. Federalism, of course, spans issues that go beyond economics. For example, in the 1960s, 1970s, and 1980s, civil rights advocates urged a more active role for the federal government, while those who resisted emphasized states' rights. This chapter focuses on economic issues, for example, what goods and services should be provided locally or nationally. This issue has surfaced periodically; in his 1982 State of the Union message, President Reagan called for a "New Federalism," giving states increased authority in welfare, with the federal government taking on more of the burden of paying for Medicaid. Critics argued that the New Federalism was a ploy for justifying cutbacks in federal assistance to states and localities, as a way of reducing the size of the federal government. Indeed, between 1980 and 1986, federal grants decreased from 3.3 percent of GDP to 2.6 percent. During the mid- and late 1990s, with a Republican majority in Congress, there were renewed demands for state control of federal programs that helped fuel the welfare reform of 1996.

This chapter briefly describes the broad division of responsibilities, then focuses on the central economic issues in fiscal federalism. It concludes with a few brief remarks about the underlying politics and philosophy in the debate.

THE DIVISION OF RESPONSIBILITIES

The relationships between the federal government and the states and localities are complex, and are not well described by a simple look at expenditures. There are two key issues: Who makes the decisions about the programs, and who pays for them? In some cases, the federal government pays for a program, and gives broad discretion to the states as to how to carry out the mandate. In other cases, the federal government essentially dictates all the terms, and the states simply administer the program.

For instance, in the SNAP food stamp program, eligibility standards and amounts are determined federally, and the states just administer the program. In some cases, the federal government gives **matching grants**—the state determines the level of expenditure (within limits) and the federal government pays a portion of the costs, which may depend on the per capita income of the state. In other cases, the federal government provides a **block grant**—a fixed amount of money subject to general expenditure guidelines. The state then bears the full costs of any expenditures above that amount. At one time, the federal government provided **general revenue sharing**—block grants that could be used for any purpose. (The federal government was sharing its revenues with the states, based on the presumption that the federal government could raise revenues more efficiently but states could make certain types of expenditure decisions more effectively.) Today, it no longer does this, but there are efforts to convert matching grants for specific purposes such as welfare into block grants for those purposes. In 1996, the AFDC (Aid to Families with Dependent Children) program was replaced with a block grant program, TANF (Temporary Assistance for Needy Families), but the food stamp program remained federally financed, and the Medicaid program continued under a matching system.

Figure 26.1 shows the fraction of government expenditures for various categories financed at the federal level. (Bear in mind that expenditures give only a partial view of the role of each level of government in each activity.) States and localities retain most responsibility for education (primary, secondary, and public tertiary), public safety (police and fire protection), and transportation (public roads and mass transit). On the other hand, the federal government bears major responsibility for Social Security and income support, housing and community services, medical care, and agriculture. These patterns can be seen slightly differently in Figure 26.2, which shows how states and localities spend their money. Education is the single largest expenditure, followed by medical care and public safety.

Just as there is a division of responsibility between the federal government, on the one hand, and state and local governments on the other,

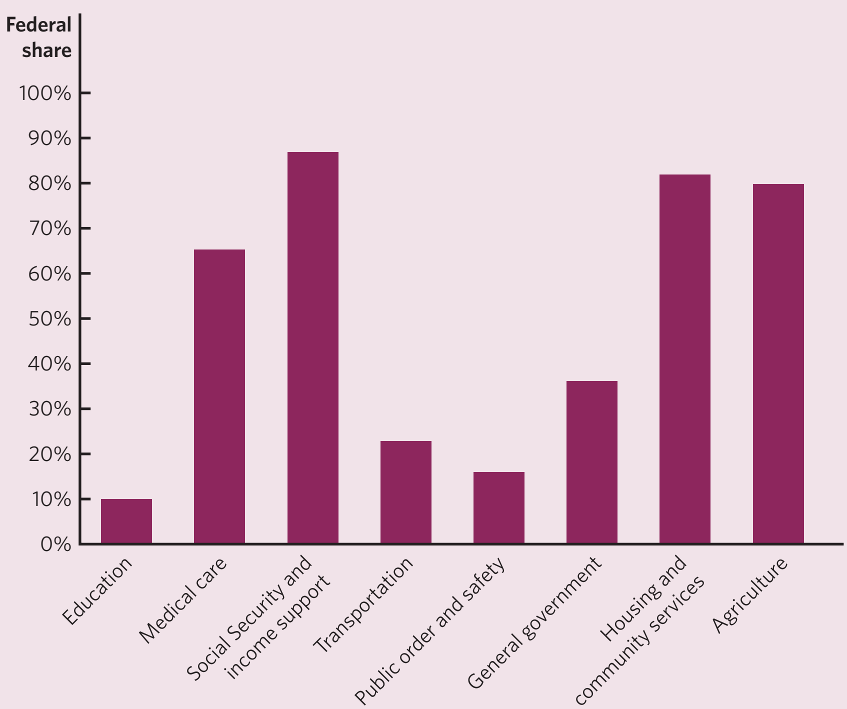


FIGURE 26.1

FRACTION OF GOVERNMENT EXPENDITURES FOR SELECTED CATEGORIES FINANCED AT THE FEDERAL LEVEL, 2008

The federal government finances most public sector spending on Social Security and income support, medical care, housing and community services, and agriculture, but state and local governments finance most public sector spending on education, policing and firefighting, and transportation.

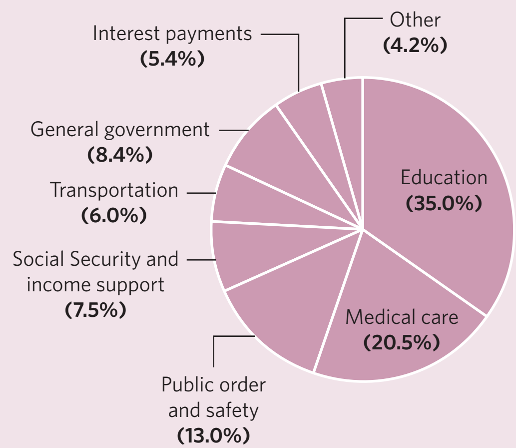
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts Tables*, Tables 3.16 and 3.17.

FIGURE 26.2

ALLOCATION OF STATE AND LOCAL EXPENDITURES IN 2008 (TOTAL EXPENDITURES OF $2.02 TRILLION)

Education is the largest state and local expenditure, followed by medical care, public safety, and income support programs.

SOURCE: U.S. Department of Commerce, *National Income and Product Accounts Tables*, Table 3.16.



so there is a division of responsibility between state governments and local governments. The division is a complicated one, involving financing, regulation, and administration. Thus, elementary and secondary schools are almost all run by local communities, but half the financing comes from the states, which also impose a variety of regulations. This is part of a complex set of intergovernmental transfers between states and local governments—almost one-third of total local government revenue comes from state grants. Thus, whereas almost 90 percent of public welfare and 60 percent of highway expenditures occur at the state level, almost all water and sewerage, solid waste, housing and community development, firefighting, and police expenditures occur at the local level.[1]

When the United States is placed in an international comparative context, no clear pattern emerges among high-income countries regarding division of responsibilities between different levels of government for most functions—the diversity is remarkable, with the exception of social protection, which is predominantly a central government responsibility (see Figure 26.3). For example, although health care is usually a central government responsibility, in Sweden, most health expenditures are by local government, and in Spain, health care is primarily a state-level responsibility. Similarly, in most countries, public safety is a central government responsibility, but in the United States and Germany, most public safety expenditures are at the subnational level.

[1] U.S. Census Bureau, "State and Local Government Finances and Employment," *2012 Statistical Abstract*, Tables 454–456.

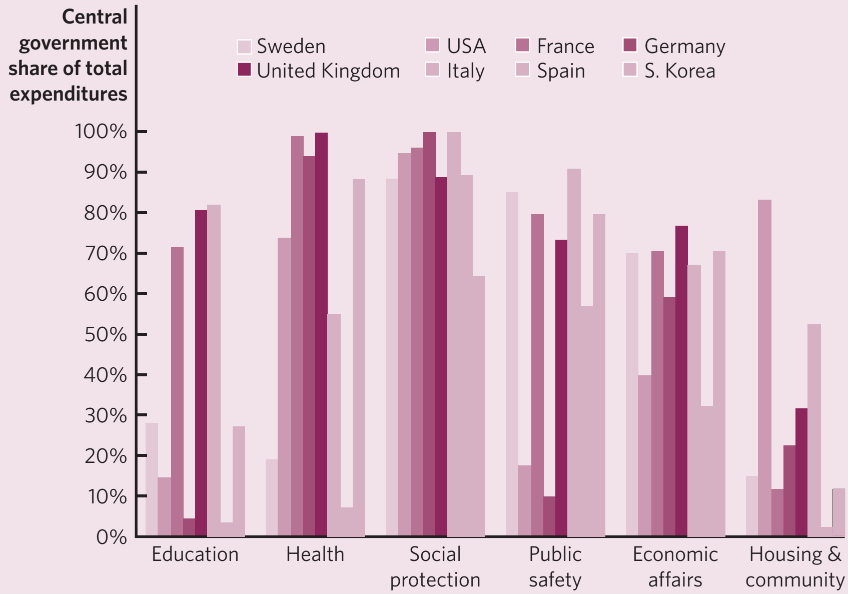


FIGURE 26.3

INTERNATIONAL COMPARISON OF CENTRAL GOVERNMENT SHARE OF SELECTED FUNCTIONS, 2010

With the exception of social protection, there is remarkable diversity among high-income countries in the division of responsibility between levels of government.

SOURCES: "Government Expenditure By Function," *OECD.StatExtracts*; and World Bank World Development Indicators.

OTHER INTERACTION BETWEEN THE FEDERAL GOVERNMENT AND THE STATE AND LOCAL GOVERNMENTS

The federal government affects the states and localities in a variety of other ways, besides providing grants. Its regulations and the federal tax code affect states and localities, just as they affect private businesses.

REGULATION The Constitution restricts the laws that states can pass. The states cannot enact legislation that deprives an individual of the right to a trial, no matter how heinous a crime he or she may have committed, nor can states use racial or religious grounds to bar an individual from holding a job. Many Supreme Court decisions in recent years have countered state actions that are in violation of the Constitution.

State and local agencies may also be subject to the same pollution and environmental regulations that apply to private firms and individuals. In some cases, the federal government has mandated that state and local governments provide certain services (such as access facilities for the handicapped) without providing the requisite funds. Not surprisingly, the states and local communities have complained that if the federal government attaches such importance to these services, it should also finance them (see case study, "Unfunded Mandates").

INCENTIVES Sometimes the federal government imposes its will through eligibility requirements for grants. For instance, until December 1995 transportation funds were made contingent upon maintaining speed limits of 55 miles per hour in urban areas and 65 in nonurban areas; educational funds are still made contingent upon having adequate affirmative action programs.

TAX EXPENDITURES One of the important ways in which the federal government affects state and local expenditures is through the tax expenditures associated with the personal and corporate income taxes. These expenditures were estimated at approximately $100 billion in 2011. For instance, interest on state and local bonds is not subject to federal taxation, and state and local income and property taxes are deductible from individual federal income taxes. As we shall see, this not only can be thought of as a subsidy to states and localities, but also provides an incentive for greater expenditures at the state and local level.

THE SIZE OF FINANCIAL TRANSFERS

Chapter 2 emphasized that the magnitude of governmental expenditures does not provide a complete picture of government's role in the economy. Similarly, the magnitude of federal transfers to states and localities does not show the extent to which state and local government expenditures are affected by federal activities. Still, several features of these transfers are worth noting. First, they grew immensely between 1929, when they amounted to just 1.3 percent of state and local government revenues, and 1970, when they amounted to one-fifth. There were some fluctuations over the next three decades, but their share had risen to one-fourth by 2005 and stands at 28 percent in the aftermath of the Great Recession. As a share of total federal expenditures, grants to state and local government have risen from 12 percent in 1970 to 17 percent today. Second, federal aid appears to be more important at the state level than at the local level, accounting for slightly more than one-fourth of state revenue but just over 3 percent of local revenue.[2]

These figures are deceptive, however. Much of the money granted to states is passed through to local governments. Transfers from state to local governments account for about one-third of total local revenue.

[2] Executive Office of the President, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2013, Analytical Perspectives* (Washington, DC: Government Printing Office), Table 18-2; and U.S. Census Bureau, "State and Local Government Finances and Employment," *2012 Statistical Abstract*, Tables 452 and 455.

UNFUNDED MANDATES

By 1994, the issue of unfunded mandates had been festering for a long time. Even pieces of legislation for which there was widespread support imposed financial burdens on states and localities that they found difficult to meet. For instance, the Americans with Disabilities Act required that states and municipalities ensure access to public buildings and public transportation by the handicapped. The reauthorization of the Clean Water Act brought the issue to a head. Communities realized that they would have to pay millions for new sewage treatment facilities.

Critics of unfunded mandates argued that just as Congress had committed itself not to pass additional expenditures unless it could finance them, so too it should commit itself not to pass additional mandates on states and communities unless it paid for them. The unfunded mandates issue was also seized upon by those who wanted to cut back government activities in general. They saw it as one way of ensuring, for instance, that no new environmental legislation could be passed. It was precisely this aspect that made the unfunded mandates issue so alarming.

Economists pointed out that some of these "mandates," such as those involved in the Clean Water Act, did not ask localities to assume an "unfair" burden; they mandated only that localities not impose an externality on other communities. By failing to treat sewage adequately, some communities were imposing costs on other communities.

The compromise adopted by Congress in 1995, the Unfunded Mandates Reform Act (UMRA), required that legislation that imposed costs on communities be accompanied with an estimate of the magnitude of those costs. Then, at least, Congress could judge whether those costs were reasonable, and whether the benefits of the legislation commensurate with those costs.

UMRA is still in effect today, and the more than 10,000 cost estimates of intergovernmental mandates submitted to Congress by the Congressional Budget Office since January 1996 have had a modest positive impact by making the costs of proposed federal mandates transparent.

SOURCE: Robert Jay Dilger and Richard S. Beth, *Unfunded Mandates Reform Act: History, Impact, and Issues* (Washington, DC: Congressional Research Service, June 2014).

Similarly, 64 percent of federal money transferred to state and local governments is passed on to individuals, primarily through Medicaid and income security expenditures. Medicaid reimbursements account for a growing proportion of federal aid to states. In 1973, they accounted for 11 percent of federal grants; in 2011, Medicaid accounted for 45 percent of transfers to state and local governments.[3]

Even these Medicaid statistics are misleading. States have learned how to use the Medicaid program as a form of general revenue sharing. To see how the "scam" works, assume some hospital increases its charges

[3] Executive Office of the President, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2013, Analytical Perspectives* (Washington, DC: Government Printing Office), Table 18-1; and U.S. Census Bureau, "State and Local Government Finances and Employment," *2012 Statistical Abstract*, Tables 454 and 455.

by $1000, with the state picking up $500 and the federal government picking up $500. The hospital could then rebate, say, $800 to the state. The hospital is better off (it has $200 more to spend), the state is better off (it has $300 to spend), and only the federal government is worse off. Expenditures for health care for the poor go up, but not because services go up or because more resources are devoted to the poor.

Financial transfers are also very important in developing economies, averaging over 40 percent of subnational expenditures and reaching twice that share in some countries. The purpose of these transfers is to close a fiscal gap created by central government assignment of more expenditure responsibility than subnational governments can pay for: subnational expenditures average about one-fourth of total public sector expenditures in developing economies, but subnational revenue averages only one-sixth of total public sector revenue. These central government transfers are used primarily to finance the key subnational responsibilities of education, health, and general government services.[4]

PRINCIPLES OF FISCAL FEDERALISM

In the previous section, we described the various activities that are undertaken at each level of government: the division of responsibilities. To a large extent, this division of responsibilities evolved over time. The Constitution, which set forth the framework within which the division of responsibilities occurs, was written more than 200 years ago, well before the development of the modern theory of public finance, and before notions of public goods even existed.

With the development of the modern theory of public finance, however, we can ask: What principles should guide the assignment of responsibilities? Are some assignments more likely to lead to efficiency, or to decisions about the level or kind of public goods being produced that are more in accord with the preferences of citizens? This section sets forth some of the key principles.

NATIONAL PUBLIC GOODS VERSUS LOCAL PUBLIC GOODS

For some kinds of goods, there is a strong presumption for federal provision. These are **national public goods**, whose benefits accrue to everyone

[4] A. Shah, "Fiscal Decentralization in Developing and Transition Economies," World Bank Policy Research Working Paper 3282, Washington, DC, April 2004.

in the nation. In contrast, the benefits of **local public goods** accrue to residents of a particular community. National defense is a national public good; traffic lights and fire protection are local public goods.

Just as most goods publicly provided at the national level are not pure public goods, most goods publicly provided at the local level are not pure public goods. For some goods, such as public libraries, exclusion is easy but undesirable, as the cost of providing access to an additional individual is almost zero. Some goods that local governments provide, such as education and public hospitals, are essentially private goods; exclusion is easy, and the costs of providing services to additional individuals are significant (see Chapter 5). By the same token, some local public goods are not purely local; some of the benefits accrue some of the time to those living in other communities.

The argument that if there is to be an efficient supply of public goods they must be provided publicly implies, by extension, that if there is to be an efficient supply of *national* public goods, they must be provided at the national level. If it were left up to each community to provide for national

INTERNATIONAL PUBLIC GOODS

Just as there are some public goods whose benefits accrue only to those living inside a particular community, there are some public goods whose benefits accrue to people living all over the world. Just as there will be an undersupply of national public goods if the provision is left to local communities, there is likely to be an undersupply of **international public goods** if the provision is left to national governments.

There are at least four important categories of such international public goods. The first, the global environment—the earth's atmosphere and the oceans that surround the continents—is perhaps the most obvious. Even though increases in greenhouse gases are likely to affect different countries differently, the overall concentration of greenhouse gases is the result of the cumulative actions of all the individual countries. The second, international security, can potentially affect almost everyone in the world, as it did during the two world wars of the twentieth century. The third is knowledge. The marginal cost of an additional person *anywhere in the world* having a bit of knowledge is zero—it does not subtract from what others know (although it may reduce the economic rents that they can obtain from the knowledge, and the marginal cost of *transmission* of knowledge is not zero). Furthermore, at least for many types of knowledge, exclusion is difficult, if not impossible. The fourth is international economic stability. An economic crisis in one country can spread to other countries, just as a disease in one person can infect others. (In fact, economists refer to the process as *contagion*.) Thus, maintaining international economic stability and containing the impact of crises is viewed as an international public good of first-order importance, and the international community has set up international financial institutions—the International Monetary Fund and the World Bank—to provide assistance in the event of a crisis.

LOCAL, NATIONAL, AND INTERNATIONAL PUBLIC GOODS

- *Local public goods:* public goods whose benefits are limited to those living in a locality
- *National public goods:* public goods whose benefits accrue to everyone in the nation
- *International public goods:* public goods whose benefits are global in nature

public goods, there would be free rider problems, just as there would be if the provision of national public goods were left up to individual households and firms.

DO LOCAL COMMUNITIES PROVIDE LOCAL PUBLIC GOODS EFFICIENTLY?

Although there is a presumption that the federal government should provide national public goods, the question remains: Should the provision of local public goods be left up to states and localities?

In a remarkable article written almost sixty years ago, Charles Tiebout of the University of Washington argued that one could think in terms of local communities' competing with each other to supply local public goods to citizens—efficiently, in the quantities and forms they want—just as firms compete to supply conventional private goods.[5] He argued that just as competition among private firms leads to the efficient provision of private goods, so, too, competition among local communities leads to efficiency in the provision of local public goods. This hypothesis is called the **Tiebout hypothesis**. The following section explores the Tiebout hypothesis—including its limitations—in greater depth.

TIEBOUT HYPOTHESIS

Chapter 3 discussed the rationale for government activities. The fundamental theorem of welfare economics—Adam Smith's "invisible hand"—implies that in the absence of a market failure, such as public goods, the economy will be Pareto efficient. Individuals, all acting in their own self-interest, will make decisions that lead to Pareto efficiency. Competition among producers leads them to supply the goods individuals want at the lowest possible cost.

An analogous argument can be made for the provision of local public goods and services by state and local governments, as distinct from the federal government. Competition among communities, it is argued, will

[5] See C. Tiebout, "A Pure Theory of Local Expenditure," *Journal of Political Economy* 64 (1956): 416–424.

result in communities' supplying the goods and services individuals want and producing these goods in an efficient manner.

Tiebout was originally concerned with the problem of *preference revelation* discussed in Chapter 9: individuals reveal their preferences for private goods simply by buying goods, but how are they to reveal their preferences for public goods? When individuals vote, they choose candidates who reflect their overall values, but they cannot express in detail their views about particular categories of expenditures. Only limited use of referenda is made in most states. Even if individuals were asked to vote directly on expenditures for particular programs, the resulting equilibrium would not, in general, be Pareto efficient.

Tiebout argued that individuals could "vote with their feet"—their choice of communities revealed their preferences toward locally provided public goods in the same way as their choices of products revealed their preferences for private goods. Moreover, just as there are incentives for firms to find out what commodities individuals prefer and to produce those commodities efficiently, so are there incentives for communities to find out what kinds of community-provided goods individuals prefer, and to provide them efficiently. This is seen most strongly in the case of community developers. In recent years these developers, recognizing that many individuals would like more security and more communal facilities (swimming pools, tennis courts) than are provided by the typical city, have formed large developments providing these services. Because these communities meet the needs of the individuals better than the available alternatives, individuals are willing to pay higher rents (or spend more to purchase homes in these communities). This gives developers a return for their efforts to ascertain what individuals want and to meet these desires.

More generally, communities that provide the services individuals like and provide them efficiently will experience an influx of individuals; communities that fail to do so will experience an outflux. Such migration (with its consequent effect on property values) provides essentially the same kind of signal to city managers that the market provides to a firm's managers (a firm that fails to provide a commodity individuals like will find its sales declining; a firm that succeeds will find its sales increasing). Politicians, sometimes under pressure from the electorate, respond

TIEBOUT HYPOTHESIS

Competition among communities ensures efficiency in the supply of local public goods, just as competition among firms ensures efficiency in the supply of private goods.

Limitations:

- "Market failures"
    - Externalities: decisions of community have effects on others
    - Imperfect competition: limited number of communities
- Tax competition may simply lead to lower taxes on businesses
- Redistribution—with free migration and local competition, there will be no (or, at most, limited) redistribution at local level

to these signals in much the same way as a firm's managers respond to market signals.

The analogy is an instructive one. Under certain assumptions, the separate decisions of each community lead to a Pareto efficient allocation, just as the separate decisions of firms and individuals concerning private goods lead to Pareto efficiency.

But these assumptions generally do not hold. And even were they to hold, the inequality in the distribution of welfare across communities might be unacceptably large.

The qualifications to the Tiebout hypothesis closely parallel those we discussed in Part 2, concerning the circumstances in which market allocations might not be Pareto efficient or, even if efficient, might not be desirable.[6] The two most fundamental qualifications are the presence of market failures and dissatisfaction with the distribution of income.

MARKET FAILURES

The most important "market failures" have to do with externalities and imperfect competition.

EXTERNALITIES The actions of one community may have marked effects on other communities. If a community constructs a smelly sewage plant or allows the development of an industrial area at its boundary, in a location such that the winds blow the bad odors over the neighboring communities, an important externality results. We sometimes refer to these externalities as *spillovers*. Not all spillovers are negative. Some economists believe that there are important public benefits from having an educated citizenry, and that they provide some justification for public support of education. To the extent that this is true, and to the extent that individuals move away from the community that provided them with a free education, there are spillovers from a local community's public education system.

Migration and location inefficiencies may be thought of as a particularly important class of externalities. Individuals who move into a community bring both benefits and costs: they may increase the tax base, but also

[6] Since Tiebout, an extensive literature has developed evaluating the conditions under which the result is valid. See, in particular, J. E. Stiglitz, "Public Goods in Open Economies with Heterogeneous Individuals," in *Locational Analysis of Public Facilities,* ed. J. F. Thisse and H. G. Zoller (New York: Elsevier–North Holland, 1983), pp. 55–78; J. E. Stiglitz, "Theory of Local Public Goods," in *The Economics of Public Services,* ed. M. Feldstein and R. Inman (New York: Macmillan, 1977), pp. 274–333; T. Bewley, "A Critique of Tiebout's Theory of Local Public Expenditures," *Econometrica* 49 (1981): 713–740; and G. R. Zodrow and P. Mieszkowski, "Pigou, Tiebout, Property Taxation, and the Underprovision of Local Public Goods," *Journal of Urban Economics* 19 (1986): 356–370.

may lead to increased demands on public services and greater congestion, for instance, of roads and parks. Because in many cases they neither pay for these costs nor are compensated for the benefits they confer, there are likely to be inefficiencies in location decisions. Many countries have become increasingly concerned about what they view as excessive concentration of population in the major cities (London, Paris, Mexico City), and have developed decentralization policies to attain what they consider a more efficient pattern of location.

COMPETITION AND PROFIT MAXIMIZATION A central assumption underlying the results concerning the efficiency of market economies is that there are many profit-maximizing firms. The Tiebout hypothesis similarly assumes the existence of many competing communities.[7] In most areas, there is only a limited number of competing communities; there is, in effect, only limited competition. Moreover, communities do not decide which goods and services to provide on the basis of any simple profit-maximization criterion, but by a political process along the lines discussed in Chapter 9. The kinds of inefficiencies to which this may give rise will be described in the next chapter. Here, we simply note that limited competition provides an explanation for why we should be skeptical about the Tiebout hypothesis.

TAX COMPETITION Tiebout's model suggests that competition among communities is not only healthy, but also necessary to attain Pareto optimality. However, there is another view of competition among communities that is far more negative. This view sees different communities competing to attract businesses, with the associated tax base and employment opportunities. Gains in one community are partly at the expense of losses in other communities. More generally, the competition to attract businesses results in lower taxes for businesses: in the end, businesses are the ultimate beneficiaries. In this perspective, it would appear preferable for communities to agree not to compete.

Earlier, we pointed out that the incidence of taxes imposed by local communities had to be on immobile factors, as the mobile factors could move to escape taxation. Capital (and businesses, more generally) is mobile; the competition to attract businesses through tax concessions is just a reflection of this reality. If communities agreed to give no tax concessions, competition would almost surely take other, probably more wasteful, forms,

[7] Indeed, there must be so many that all residents within each community who have the same skills also have the same tastes for public goods. Another implication is that (provided voters are rational) there would be complete unanimity in voting. Obviously, neither of these conditions is satisfied. See R. W. Eberts and T. J. Gronberg, "Jurisdictional Homogeneity and the Tiebout Hypothesis," *Journal of Urban Economics* 10 (1981): 227–239; and H. Pack and J. Pack, "Metropolitan Fragmentation and Local Public Expenditure," *National Tax Journal* 31 (1978): 349–362.

such as providing enhanced public facilities like roads for the businesses. (If even this were somehow stopped, communities that had higher tax rates because they had a lower tax base would find it impossible to attract businesses.) From this perspective, then, trying to stop **tax competition** is like trying to stop competition elsewhere in the economy. Not only are such attempts likely to be ineffective, but to the extent they are effective, they are also likely to lead to other problems, including inefficiencies.

Nonetheless, an increasingly popular alternative to this "race to the bottom" characteristic of escalating wars of tax incentives between dueling local governments is **economic gardening**: nurturing local businesses and making investments to support both existing and new businesses. The premise of economic gardening is that tax competition is usually expensive and counterproductive—it either fails to attract businesses, or attracts businesses that would have come without tax incentives because of market-related factors and the quality of local public infrastructure and services. Moreover, proponents of economic gardening claim that tax incentives deprive local government of the resources needed to serve all businesses in its jurisdiction, and predicate future success on maintaining a subsidized cost advantage that will be increasingly difficult to maintain.

As in other areas, complete collusion, were it successful, could have real effects. If all communities were able to agree not to compete for business, and agreed, say, to impose a uniform tax on business, then the communities would gain at the expense of businesses. Such a tax would be equivalent to a federally imposed tax.[8] The debate on tax competition illustrates the marked advantages the federal government has in imposing taxes.

REDISTRIBUTION

Redistribution—the second basic qualification to the Tiebout hypothesis—may be a more important explanation of the role of the federal government than the market failures we have just described. There is concern about the distribution of income both among individuals and across communities.

INEQUALITY AMONG INDIVIDUALS Should the extent of redistribution—the level of welfare payments—be a local or national decision? Is "redistribution" a local public good? Assume that individuals in some community believe strongly that no individual should live in a slum, and so they provide a good public housing program, whereas individuals in some other community have different ethical concerns. Is there any

[8] There remains the problem of tax competition among countries.

reason why individuals in the first community should attempt to impose their ethical beliefs on the second, by attempting to make minimal housing standards a national rather than a local issue?

The answer is yes. The reason is that, with relatively free migration, the extent of redistribution that is feasible at the local level is very limited. Any community that decides to provide better housing for the poor, or better medical care, might find itself faced with an influx of the poor. Communities have an incentive to try to appear unattractive to the poor, so they will move on to the next community. Some communities, for instance, do this by passing zoning laws that require multiacre lots.[9] Others do it by limiting the provision of certain public services that are particularly valued by the poor and for which the wealthier have good private substitutes, such as bus services.

Indeed, if there were perfect competition among communities, the efforts to provide local public services at least cost to the taxpayers would result in taxpayers' paying taxes only commensurate with the benefits they themselves received. A community that had no welfare program and succeeded in excluding most of the poor would be able to provide public services (e.g., education, sewage treatment, libraries, etc.) at lower tax rates than a community that had an ambitious welfare program (e.g., public housing, good medical care, etc.) and educational programs aimed at disadvantaged children. The fact that competition is frequently limited, migration is slow, and decisions concerning public services are made politically means that there often are local (and state) redistribution programs—but these remain limited.

INEQUALITY ACROSS COMMUNITIES We have already noted that there are marked differences among the states in per capita income. For a poor community to provide the same level of services as a rich one requires that it levy much higher tax rates. Indeed, we see enormous variation in per capita expenditures and tax rates across the United States. Per capita expenditures at the state level in 2008 varied from lows of \$4079 in Texas, \$4146 in Nevada, and \$4190 in Florida, to highs of \$14,701 in Alaska, \$9534 in Wyoming, and \$8182 in Hawaii, with an average for the country of \$5696.[10] Total state and local taxes paid in 2008 by a typical family of four earning \$75,000 ranged from the high end at 12.4 percent of income in Philadelphia, 11.2 percent in Detroit, and 10.9 percent in New York City, to the low end at 4.4 percent of income in Jacksonville, 5.5 percent in Las Vegas, and 5.6 percent in Houston.[11]

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[9] Courts have recently restricted the use of zoning as an exclusionary device.

[10] U.S. Census Bureau, "State and Local Government Finances and Employment," *2012 Statistical Abstract*, Tables T-13 and 454.

[11] U.S. Census Bureau, "State and Local Government Finances and Employment," *2012 Statistical Abstract*, Table 447.

Why should we be more concerned with the inequality associated with locally provided public goods (and tax rates) than we are with inequality in general? Is there any reason why there should be specific federal programs directed at reducing this particular kind of inequality? If we want more redistribution, why not simply impose a more progressive federal tax, letting individuals then choose how to spend their money? If they wish to live in communities that spend more or less on local public goods, why not let them? The issues are analogous to those that arose in earlier chapters concerning whether the government should have specific policies directed at decreasing the extent of inequality of access to specific goods, such as medicine, food, and housing. The concept of *specific egalitarianism* was introduced—the view that the consumption of certain commodities should not depend on one's (or one's parents') income or wealth. Education, the most important locally and publicly provided good, is one of those goods for which the strongest argument for equality of access can be made.

Several arguments, however, can be made against providing programs aimed at reducing inequality in the provision of local public services.

1. *Consumer sovereignty.* The first is the standard "consumer sovereignty" argument: individuals should be allowed to choose the goods they prefer. The argument is that the federal government should not force its preferences—for food, housing, or education—on local communities. Programs aimed at reducing inequality in the provision of local public goods (to the extent that they are effective) distort consumption patterns; they may result in greater consumption of "local public goods" and less consumption of private goods than a redistributive program providing cash to individuals. Categorical grants (again, to the extent that they are effective) cause a distortion in the mix of locally provided goods; they may, for instance, result in more education and urban redevelopment and less frequent sewage collection. Whenever there are such distortions, there is a deadweight loss.

   This consumer sovereignty argument, though relevant, is somewhat less forceful for some locally provided goods than for others. For instance, decisions concerning elementary and secondary school education are made not by the individual but by his or her parents; and decisions concerning local public goods are made by a political process, which need not yield efficient outcomes, as we saw in Chapter 9.

   Moreover, much of the consumer sovereignty argument is predicated on the belief that individuals are well informed and rational, but in many cases, these assumptions are not valid. Parents seldom have information about the quality of schools and typically send their children to the nearest school, even when they have a choice.

2. *The difficulty of targeting communities for redistribution*. A second argument against programs aimed at redistributing income across communities (localities, states) is that such programs are not well targeted. Most communities contain a mix of poor and rich individuals. A program aimed at redistributing resources to a community whose average income is low may simply result in a lowering of the tax rate; the program's main beneficiaries will thus be the rich individuals within the poor communities. On the other hand, certain specific programs, such as the school lunch program, may be more effective in redistributing income to *children* than programs aimed at redistributing income among families.

3. *Location inefficiencies*. A third argument is that programs redistributing income across communities result in location inefficiencies. They distort the decisions of individuals about where to live and the decisions of businesses about where to locate.

   The United States is a very mobile society; we move often, and frequently quite far. There have been large migrations from the rural South to the urban North, and from the Snow Belt to the Sun Belt. A variety of reasons induce individuals to move, but economic considerations are among the more important. These include not only individuals' opportunities for employment and the wages they receive, but also the taxes that are imposed and the public goods that are provided. As demands and technologies change, economic efficiency requires that individuals move to where they can be more productive. This will necessitate that some localities, and indeed even some regions, experience declining populations, whereas others experience rapidly rising populations. Federal aid aimed at redistributing income from one locality to another may interfere with the efficient allocation of labor and capital. The level of taxes and public services provided by one community will not correctly reflect the economic potential of that community. The inefficiencies to which this gives rise may be small in the short run but may become large in the long run. Individuals will be encouraged to stay where they are rather than move to more productive localities. Indeed, it might be better to use the same funds to subsidize emigration out of the unproductive areas. Similarly, with new highway systems, it may no longer be efficient to have the larger agglomerations of population associated with inner cities. Thus, aid to central cities may serve to perpetuate these inefficient patterns of location.[12]

Note that these inefficiencies arise from attempts to redistribute income among communities. If our basic concern is with inequality

[12] On the other hand, the aid may compensate for positive externalities produced by the inner cities.

among individuals, redistribution should be aimed at individuals, not at regions or localities.

In addition, specific redistributive programs, if they are not well designed, may give rise to large distortions. A program aimed at remedying measured housing shortages among the very poor, by providing federal subsidies, may encourage communities to undertake actions that exacerbate these shortages (such as rent control). Critics worry that a program to bail out cities that have borrowed excessively and appear to be in danger of defaulting on their bonds may encourage other communities to borrow more than they otherwise would, knowing that if they get into trouble the federal government is there to rescue them.

However, there is little evidence that such adverse incentives (sometimes called *moral hazard*) have played an important role. Some of the most widely noted instances of communities that have gotten into financial troubles are connected with exploitation by Wall Street, in its selling of inappropriate financial products. Others are connected with declines in America's conventional manufacturing—its deindustrialization—with particular adverse effects on communities in which such industries have been central. These financial problems have been exacerbated by the fractionalization of metropolitan areas, which has left many inner cities in very bad financial straits even as their surrounding suburbs prosper.

An important consideration in ascertaining appropriate policies for cities in distress is the consequences for "innocent" victims (e.g., children who will get an inadequate education unless something is done to provide these cities with some assistance).

OTHER ARGUMENTS FOR LOCAL PROVISION

The concept of local public goods provides the central argument for the provision of certain public goods locally, but several other arguments have been put forward for assigning greater responsibility for the provision of collective goods to the local level—even when the goods are not pure local public goods, or even when doing so may limit the scope for redistribution. These arguments have played an important role in recent political debates in the United States. One is that by delegating more responsibility to local communities, there can be more adaptation to the circumstances and preferences of those who benefit from the good. Moreover, there is more likely to be active involvement of citizens—for example, in schools—when they are the responsibility of local communities; this involvement leads to higher-quality public services.

Moreover, at the local level, individuals see more clearly the link between benefits and costs (what they have to pay in taxes); when people sense clearly the link between government benefits and taxes, they are less likely to ask for benefits that are not worth the costs, and are more likely to demand efficiency in the provision of benefits. Moreover, there can be more experimentation, which provides information that is particularly valuable in designing programs in areas such as welfare, where there is a general sense of major need for improvement.

Besides these analytic arguments, some may push for delegating more responsibility to states and localities because they believe that the political process will result in decisions that are different—and more to their liking—than if the decisions are made at the national level. For instance, many believe that assigning states and localities more of the responsibility for decisions concerning welfare programs will result in a more effective containment of costs.

However, local and state politics may play out in other ways as well. In many states, rural areas have a political weight that is out of proportion with their population. As a result, state politics can be much more conservative, biased against urban areas, and less concerned about issues of inequality. For instance, states were left with discretion in signing up for the expanded Medicaid provisions under the Affordable Care Act. The expansion was intended to reduce the number of low-income Americans who did not have access to health care. But even though the federal government was paying almost all of the costs, several states with the greatest problem of lack of coverage chose to opt out. Clearly, they did not have the interests of their poorer citizens in mind.

PRODUCTION VERSUS FINANCE

Many of the arguments typically made for local provision of public goods—that local communities are more responsive to the needs and preferences of those who actually receive the goods, that local communities have greater incentives for efficiency, and that devolving responsibility to local communities provides greater opportunities for experimentation—are mainly arguments for local *control* (local decision making) rather than local *finance*. However, there are good reasons for concern about separating finance from control. If voters of the country as a whole believe that their tax dollars should be used to finance welfare expenditures for the poor, they want to be sure that their money actually goes for this purpose, and not to finance suburban swimming pools. Some controls on expenditure are necessary. The issue is one of degree: how much control? By imposing more controls, there may be greater assurance that the money is used in the way intended, but there is a cost—more bureaucracy, less adaptability to local circumstances, and less experimentation. In the case of the welfare program, prior to the 1996 reforms, there was a consensus that more local autonomy was needed, and the federal government granted the vast majority of states **waivers** of federal rules to allow them to introduce specific experiments. A similar debate is now under way regarding the appropriate degree of state discretion in the context of national health care reform.

When responsibility for decision making devolves downward from the federal government, there is a question of how far downward: to the states, to subunits of the states such as cities or counties, or directly to individuals? Many of the arguments for devolving responsibility suggest that the lower the level, the better. A housing program is more likely to be responsive to local needs if responsibility is given to the city or neighborhood, rather than to the state. Many argue, why involve intermediary levels of government at all? Why not simply give poor individuals housing vouchers—certificates that they can use to buy housing anywhere—giving them the decision-making responsibility over the kind of housing they want?

The discussions earlier in this chapter and in previous chapters have provided a number of reasons for not relying on vouchers or cash transfers. Promoting a society that is concerned about children and providing good public schools for all may be a more effective way of ensuring quality education and educational opportunity than giving money to parents and hoping that they will make the best decision for their children. We know that private markets often engage in exploitation, taking advantage of imperfect and incomplete information. There are hosts of other market failures that government provision may help address.

Assigning responsibility for decision making to local communities does not mean that they actually have to do the production themselves. Just as the federal government can produce goods and services directly or purchase them from private firms, the same is true at the local level. Typically, local communities are involved in the production of most of the goods and services that they provide—from police and fire protection to schools. However, there are some areas—most notably, garbage collection—that many communities contract out to private providers. (In still other localities, garbage collection is treated as a private good, with the community taking on no role at all.) The discussion of public versus private production at the local level parallels that at the national level (see Chapter 8). More recently, states and localities have been exploring new possibilities for both contracting out and complete privatization—including performance of administrative services, lease or sale of public infrastructure (especially buildings and toll roads), charter universities and charter schools, development agencies, prisons (see case study, "Privatizing Prisons" in Chapter 8), and even state lotteries.

EFFECTIVENESS OF FEDERAL CATEGORICAL AID TO LOCAL COMMUNITIES

The intention of federal categorical aid to local communities is to encourage local spending on particular public services. Aid to bilingual education, to vocational education, and to school libraries is intended to result in an increase in expenditures in each of these categories. How effective is this aid? Do federal funds just substitute for local funds, or do they actually result in more expenditures for the intended purpose?

From a theoretical perspective, the issue is precisely the same as one that we discussed in Chapter 10. How effective is categorical aid to individuals in encouraging expenditures, say, on food or housing? The answer depends on whether there is a substitution effect or just an income effect.

We wish to compare three types of federal aid to local communities—a block grant not tied to any specific use, a block grant tied to a specific purpose, and matching aid for a specific purpose.

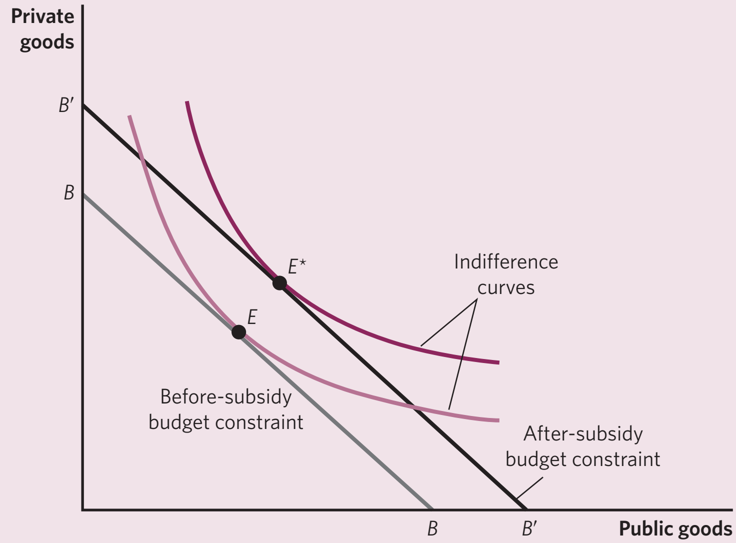
Figure 26.4 shows the budget constraint of the community. (We simplify by assuming all individuals within the community are identical, so that we can ignore questions concerning differences in tastes.) The community would choose point E, the tangency between the budget constraint and the indifference curve of the representative individual. Now assume that the federal government provides a block grant to the community. This shifts out the budget constraint, to line $B'B'$. There is now a new equilibrium, E^*. It entails a higher level of expenditure on local publicly provided goods and a higher level of per capita consumption of private goods. That is, the federal aid has, in fact, resulted in lowering the tax rate imposed on individuals. The federal money has partially substituted for local community money; the community, because it is better off, spends more on publicly provided goods as well as privately provided goods.

Now assume, however, that there are two different publicly provided goods, garbage collection and education, on which the community can spend funds. We represent the allocation decision of the community between the two goods by the same kind of diagrammatic devices we have used to represent the allocation between private and publicly

FIGURE 26.4

EFFECT OF BLOCK GRANTS

A lump-sum transfer to a community will result in an increase in public expenditures, but by an amount less than the transfer; local taxes will go down.



provided goods.[13] The community has a budget constraint; it needs to divide its total budget between the two goods, as represented by Figure 26.5. The community also has indifference curves between the two goods. The initial equilibrium is represented in Figure 26.4 by *E*. Now with the federal aid, the budget constraint has moved out, and the new equilibrium is *E**. Does it make any difference whether the government specifies that the funds be allocated to one public good or the other? Not usually. As long as the amount of federal aid that is tied to a good is less than the amount that the community wishes to spend on it, federal aid will substitute for local support for this particular good, on an almost dollar-for-dollar basis. That is, if the community spends, say, 5 percent of any additional increase in its wealth on education and 5 percent on garbage collection, a federal grant of $1 million will result in $50,000 additional expenditure on education and $50,000 on garbage collection. The remaining $900,000 will be used to lower the tax rate. However, it makes no difference whether or not the government stipulates that the money it gives be used for education, as long as the community was previously spending more than $1 million on education. If it were not spending this amount, then, of course, there would be greater effect on

[13] This kind of analysis assumes that we can separate the allocation decision among publicly provided goods from the allocation decision between private and public goods. This kind of separation is possible only under a fairly stringent mathematical condition on preferences known as *separability*, in which we assume that the marginal rate of substitution between public goods 1 and 2 does not depend on the level of consumption of other goods.

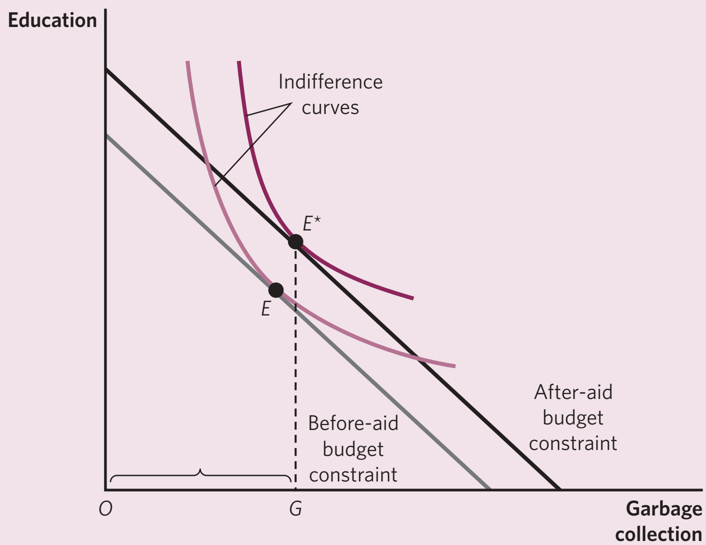


FIGURE 26.5

EFFECTS OF NONMATCHING CATEGORICAL AID

It makes no difference whether the federal government stipulates that the funds be used for garbage collection or education, as long as the size of its grant is less than the total desired expenditure. (If the government stipulates that its funds be used for garbage collection, then as long as the government gives less than the amount *OG*, the stipulation has no effect.)

its education budget; expenditure would increase by the amount that the federal aid exceeded the amount previously expended.[14]

These results for block grant categorical aid need to be contrasted with a government program of *matching* local expenditures, for instance, on libraries. Suppose the federal government matches local expenditures on a dollar-for-dollar basis. If the local community wishes to buy a book that costs $10, it costs the community only $5, as the federal government provides the other $5 with a matching grant. This arrangement obviously creates a considerable inducement to spend more on these services, as illustrated in Figure 26.6. The new budget constraint, with the subsidy for local government expenditures, is rotated around point *B*. If the community were to decide to spend nothing, it would not receive federal aid. For every dollar of privately provided goods that the community gives up, it can obtain twice as many publicly provided goods as previously. Thus, the budget constraint is much flatter. This outward shift in the budget constraint has an income effect as before, but now there is, in addition, a substitution effect. Because publicly provided goods are less expensive, the community will wish to spend more. The equilibrium will change from *E* to *E**.

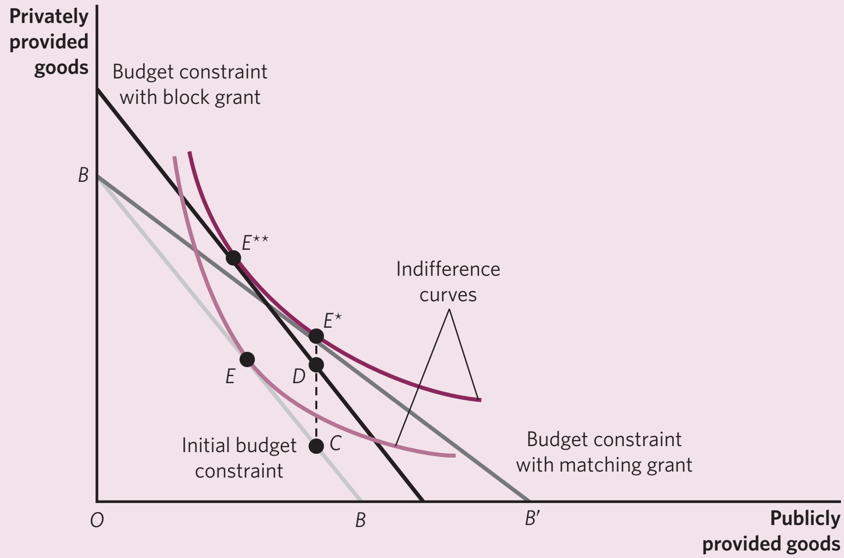
Figure 26.6 also shows the community's budget constraint with a block grant that provides the community with the same welfare as the

[14] A full analysis of this problem requires a three-dimensional diagram with education, garbage collection, and private goods on the three axes.

FIGURE 26.6

THE EFFECT OF MATCHING GRANTS

Matching grants effectively lower the price of local public goods and result in an increase in the level of consumption of local public goods. With a 50 percent matching grant, the community needs to give up only 50 cents' worth of private goods to get $1 of public goods. A block grant of *CD* gives the same level of utility as the matching grant of amount *CE**.



matching grant. (This budget constraint is clearly parallel to the before-subsidy budget constraint, and the new equilibrium at E^{**} is on the same indifference curve as E^*.) Two things should be noted: the equilibrium level of public expenditure on the public good is lower than with the matching grant, and the cost to the federal government is lower. There is a deadweight loss associated with the matching grant (of DE^*, in terms of privately provided goods).

If the matching funds are provided for a particular good, the federal aid will have a marked effect on the composition of the community's budget. It will encourage goods whose prices are lowered (perhaps partly at the expense of other publicly provided goods, whose *relative* prices can now be viewed as being higher). By the same token, it should be clear that for any given level of federal grants, if the object of the federal government is to encourage the provision of particular goods, a system of matching grants is far more effective than block grants—a lump-sum subsidy—whether restricted or not.

THEORY AND PRACTICE Evidence from actual government behavior supports our prediction that matching grants are more stimulative for local governmental spending than block grants. However, it does not support our prediction that nonmatching grants for specific purposes have the same effects as a lump-sum increase in private income; the evidence suggests that categorical programs do have an effect on government budgets.[15] This has been referred to as the **flypaper effect**: money sticks where it hits.[16] Several explanations have been offered. One argument is that voters do not perceive the true marginal price of public expenditures when nonmatching grants are made; marginal costs exceed average costs, and voters are more aware of the latter than the former. Another explanation is that, at least in the short run, government bureaucrats have considerable discretion over their budgets. If they receive additional funds, the voters do not immediately know about it; and even if they did, they do not have the means to force the bureaucrats to pass the money back to them. A third argument posits that federal administrators can ensure that the money is spent in an incremental manner; they have enough discretion to withdraw funds if they believe that the federal funds are simply being used to substitute for state funds. This argument is supported by the "maintenance of effort" requirement of many federal grant programs, whereby grant recipients must spend their state and local funds at pre-grant levels for grant-funded activities, so that federal dollars supplement normal activities rather than supplant them.

FEDERAL AID TO COMMUNITIES

Block categorical grants

- Fixed amounts for certain categories of expenditures
- Effect much like a lump sum grant, provided the grant is less than would otherwise have been spent

Matching grants

- Amount received by state or locality depends on level of expenditure
- Has both substitution and income effects—and therefore likely larger effect than comparable size block grant
- Has distortionary effect—same level of community welfare can be attained at lower cost with a block grant

THE FEDERAL TAX SYSTEM AND LOCAL EXPENDITURES

The federal government affects local expenditures not only directly through its aid programs, but also indirectly through the federal tax system. Two provisions of the income tax code have an important effect on local communities. The first is that interest on state and local bonds is completely exempt from taxation by the federal government. This means that if an individual faces a 35 percent marginal tax rate, a 6.5 percent return

[15] See E. M. Gramlich, "Intergovernmental Grants: A Review of the Empirical Literature," in *The Political Economy of Fiscal Federalism*, ed. W. E. Oates (Lexington, MA: Lexington Books, 1977), pp. 219–239.
[16] P. N. Courant, E. M. Gramlich, and D. L. Rubinfeld, "The Stimulative Effect of Intergovernmental Grants: Or Why Money Sticks Where It Hits," in *Fiscal Federalism and Grants-in-Aid*, ed. P. Mieszkowski and W. Oakland (Washington, DC: Urban Institute, 1979), pp. 5–21.

on a tax-exempt local government bond is equivalent to a 10 percent return on any other bond. After taxes, a 10 percent return yields 6.5 percent: 10% (1 − 0.35) = 6.5%. This tax exemption for state and local bonds clearly lowers the cost to state and local authorities of borrowing funds.

The second provision is that state and local income and property taxes are deductible from the federal income tax. That is, if an individual has an income of $40,000 and pays $1000 in property taxes, he or she can deduct that amount from income, and pay taxes on only $39,000. This means that if the individual is in the 35 percent tax bracket, the property tax reduces net income (what the individual can spend to buy consumption goods) by only $650. Of the $1000 in property taxes, the federal government is, effectively, paying more than one-third.

These tax benefits increase the level of expenditure on local public goods, encourage expenditures on capital projects, and induce some communities to finance their investments by debt.

Consider an idealized community in which all individuals are in the 35 percent tax bracket. If the community increases expenditures per family on education by $1000 and raises income and property taxes to finance the increased expenditures, the after-federal income tax cost to the individual is only $650. It is as if there is a federal matching grant for local public goods. The budget constraint facing the individual is identical to that depicted in Figure 26.6.

In most states, communities can borrow only to finance capital projects. If this restriction is binding (as it frequently is), the tax exemption of interest on local bonds implies that the effective cost of capital goods is lowered relative to that of current services (labor and materials); this results in a bias toward capital projects.

INEFFICIENCY OF TAX BENEFITS TO LOCAL COMMUNITIES There are four reasons why providing aid to local communities through the federal income tax system may be inefficient. We have just discussed the first: aid provides a large incentive for the public provision of goods, regardless of the efficiency with which the local communities are able to deliver these goods and services. The second reason we discussed in Chapter 21: a significant fraction of the benefits of interest exemption accrue not to the communities, but to wealthy taxpayers.

The third reason why tax exemption may not be an efficient way of subsidizing local communities is that because of competition among communities, some of the benefits may accrue to industries within the communities rather than to the communities themselves. Local communities can issue tax-exempt bonds to help finance some of the capital costs required to provide the infrastructure to attract firms. If one community does this, however, other communities respond, either by trying to attract firms to their community or by trying to prevent firms from leaving. The net effect is that the level of public goods provided to businesses may be higher than it would be otherwise. If only one community provided the higher level of public goods, it would be reflected in the price firms were willing to pay for land in that community. When all communities increase the level of public goods they provide, however, it may leave the total demand for land, and hence the level of rents, relatively unaffected.

The fourth consideration in an evaluation of federal tax and interest provisions is the inequities they create for individuals with different tastes and incomes. We have already noted that these provisions represent a considerable subsidy to the public provision of goods. Individuals who have a relatively strong preference for goods that tend to be publicly provided at the local level benefit by such measures, at the expense of those who have a weak preference for those commodities.

Because the magnitude of the reduction in effective costs of publicly provided goods depends on individuals' marginal tax rates, those who face a higher tax rate—usually wealthier individuals—receive a larger subsidy, and a larger reduction in their effective price of publicly provided goods. (To some extent, the "taste" effect and the pure income effect offset each other. Although they may receive a larger subsidy for each dollar spent by their local government, communities with wealthy individuals may actually spend less on at least certain categories of goods: for example, wealthier individuals are more likely to send their children to private schools.)

As persuasive as these arguments are to many economists, the political support for deductibility of state and local income and property taxes and preferential treatment of interest on state and local bonds remains strong enough that major changes in these deductions are unlikely in the foreseeable future.

CONCLUDING REMARKS

Some of the arguments we have given against federal assistance to communities, as opposed to individuals, may be overstated. We observed earlier that those who provide money at the federal level often have in mind specific uses for the funds. Much of the national consensus about government programs centers around access to certain basic goods and services, especially for certain groups in the population, wherever they are located: no child should go hungry, every child should have access to education (no child should be left behind), or no elderly should be left in destitution.

Although states have managed to assert their rights to administer many of these programs—and in some cases, because of their closeness to the situation, they might be able to better administer them—there remains a strong federal interest in insuring that the money is spent in the manner intended. That is why block grants, with no restriction, are limited.

But the same reasoning explains why money is given to states and localities rather than to individuals. Giving money to communities for specific purposes, for instance, to ensure that children are protected from the worst consequences of poverty, may be a far better way of achieving these objectives than giving the money to parents. Also, the goods and services for which there is a concern about access, like education and health, are often publicly supplied by local communities, especially to the poor. In some cases, like private, for-profit higher education, market provision has excelled more at identifying the poor individuals who can be exploited than at providing high-quality education at low costs. (Earlier chapters explained why many of these services have traditionally relied heavily on public provision.)

Moreover, the worry about adverse incentives is, for the most part, greatly exaggerated. Communities typically do not put themselves in the kind of dire straits that necessitate, or elicit, federal help. And the federal government often imposes "maintenance of effort" requirements—communities or states only get assistance if they have maintained certain efforts to provide benefits to their citizens.

In a dynamic economy, some communities will suffer as the demand for the products produced by their industries wanes or as patterns of living change. But it may be counterproductive to simply abandon these communities, as we have done with Detroit, MI, and Gary, IN. On their own, these communities have insufficient resources to restructure themselves, and they get set on a downward spiral: as people and businesses move out, their tax base shrinks; public services get cut back, inducing more outmigration. In these cases, federal assistance may help the communities "reinvent themselves."

Politics often play out differently at the local and state level than at the national level; local elites may have disproportionate influence. While it is often argued that governments that are closer to the people are more responsive to their needs, this does not always seem to be the case, even in democracies. The response to Obamacare provides a dramatic illustration. The poorest states—the states with the most poor people lacking health care coverage—decided not to accept the expanded Medicaid program, even though the federal government was paying 90 percent of the costs. These include states in which a century after the freeing of slaves, there was an active policy of disenfranchisement—for instance, denying or discouraging African Americans from voting with force. While the civil rights bills improved matters, it did not lead to full participation of African Americans. Clearly, the decision to reject a virtually free transfer of medical costs to the federal government was not made in the interests of the large number of the poor and uninsured living in these states.

Generally, political processes in states give more political power to rural areas, than would be reflected simply in the proportion of the population that they represent. (This is the case, for instance, if one of the two chambers of the state legislature has representation by counties, and the urban population, though large, is concentrated in a few counties.) Since rural areas are often more conservative than urban areas, the political outcomes reflect these differences in beliefs and interests. At the national level, there is often a more active civil society based on coalitions of cities, and more liberal interests countervailing the conservative bias of state politics. Much of the debate about decentralization and devolution of power reflects these differences in political powers at different levels. Similar issues arise in other countries as well.

Moreover, there is often a difference of competency in administrative/bureaucratic processes at different levels. It is not a surprise that many of the more talented people seek a bigger stage, making it easier to recruit good talent to be federal civil servants. The process can be self-reinforcing, since talented people often prefer to work with other talented people. And simply because of its larger size, the federal government can engage in more research and evaluation to assess on a more scientific basis its different programs in an attempt to improve them. (Such expenses are basically fixed costs; with larger programs, it is optimal to invest more to ensure their quality and effectiveness and promote evidence-based policies.)

All these observations provide an important caveat to the arguments concerning the benefits of decentralization, even in the case of purely local goods. But in a highly integrated economy with high mobility, there can be important externalities even from what otherwise would be purely local public goods. Less educated citizens may contribute less to the overall tax revenues and may be more likely to impose greater demands on public funds, such as for unemployment. Countries compete on the quality of their labor force and the goods produced, and a more poorly educated labor force may produce lower quality goods.

In short, the economics and politics of decentralization are complex. Various countries have experimented with different forms and degrees of decentralization, devolving various powers to lower administrative units, and giving different degrees of political (electoral) control at different levels with different financing arrangements. Some have employed the simple guidelines set forth earlier in this chapter, with considerable disappointment.

REVIEW AND PRACTICE

SUMMARY

1. The federal government regulates and subsidizes states and localities. It subsidizes them through both matching and block grants for specific purposes. In the past, it also provided general revenue sharing. In matching grants, the amount received by states and localities depends on the amount they spend. Indirect aid is provided by the exemption from taxation of interest on state and local bonds and the tax deductibility of state and local income and property taxes.
2. The arguments favoring local over federal provision of public goods are that local governments will be more responsive to the community's needs and preferences and have greater incentives to provide services efficiently. But differences in the way that state and local versus national politics play out provide a strong argument for national provision, especially in the context of growing inequality.
3. Local public goods are public goods whose benefits are limited to those living in a particular locality. The Tiebout hypothesis postulates that competition among communities results in an efficient provision of local public goods. The reasons why federal intervention may be required include market failures (externalities, particularly those associated with choice of location, and limited competition) and redistribution (the limited ability to redistribute income at the local level).
4. There are marked disparities in income per capita and in the provision of local public services across states and localities. Whether government policy should be directed at reducing inequalities across communities (rather than inequalities across individuals) is debatable.
5. Matching grants are more effective in encouraging expenditures in the direction desired, but there is a deadweight loss associated with their use. Although traditional theoretical arguments suggest that block grants, even for specific purposes, should have just income effects, and thus be equivalent to equal direct grants to the members of the community, the empirical evidence suggests the presence of a flypaper effect.
6. Tax subsidies, including the tax exemption of interest on local and state bonds, lead to increased expenditures on publicly provided goods and increased capital investment by state and local governments.
7. Tax exemption of interest on state and local bonds and other forms of tax subsidies are an inefficient way of subsidizing state and local communities. Some of the benefit accrues to wealthy investors rather than to the communities, some of the benefit is passed along to businesses rather than to the residents of the communities, and the tax subsidies discriminate in favor of high-income individuals and individuals who have a strong preference for publicly provided goods.

KEY CONCEPTS

Block grant
Economic gardening
Fiscal federalism
Flypaper effect
General revenue sharing
International pubic goods
Local public goods
National pubic goods
Matching grants
Tax competition
Tiebout hypothesis
Waivers

QUESTIONS AND PROBLEMS

1. Discuss the advantages and disadvantages of state versus national determination of eligibility standards and benefits for food stamps, Medicaid, unemployment insurance, Temporary Assistance for Needy Families, and Old-Age and Survivors Insurance.

2. In President Reagan's State of the Union message in 1982, he proposed a trade with the states: in return for their taking over responsibility for the full costs of food stamps and Aid to Families with Dependent Children, the federal government would take over responsibility for Medicaid. In addition, he proposed phasing out most categorical grant programs, possibly substituting increases in block grants. The proposal was never adopted. Evaluate these proposals using the analysis of this chapter.
3. If the income elasticity of demand for education is 1, what will be the effect on expenditures on education of a small block grant of $100,000 if the community currently spends 5 percent of its total resources on education?
4. Many matching grant programs specify that the federal government matches, on a dollar-for-dollar basis, local expenditures up to some particular maximum. Draw the budget constraint between private goods and local public goods facing a community of identical individuals. Discuss the effect of such a matching program on communities that do not go to the maximum. Discuss the effect on communities that go beyond the maximum.
5. What would you expect to be the effects on spending on education if the federal income tax deduction for state and local taxes were eliminated? Show diagrammatically why you might expect such a change to increase the relative importance of private education.
6. Consider a community in which everyone is at the 36 percent marginal tax bracket. By how much would educational expenditures be reduced by the elimination of the tax deductibility of state and local taxes, if the price elasticity of demand for education is 1?
7. On the basis of the discussions in Chapters 6 and 10, discuss the relative merits of regulation versus matching grants as devices to elicit desired behavior on the part of state and local governments.
8. Recall from Chapter 9 the median voter theory. Consider a state that imposed a proportional income tax on everyone, but assume that the median voter did not itemize his or her deductions, so this individual's federal income tax payments did not depend on state taxes. How, according to the theory, would expenditures in such a state differ from those in a state with similar average incomes but in which the median voter did itemize his or her deductions, so that increased state and local taxes reduced the individual's federal tax payments?
9. The tax reform of 1986 eliminated tax deductibility of state sales taxes, but retained it for state income taxes. What implications should this have had for how states raised revenues? In fact, the share of individual and corporate income taxes in total state revenues today is lower than it was in 1980. How might you explain this?
10. Concern about *fungibility* of funds—of states not using money in the way intended—has led Congress in some instances to impose *maintenance-of-effort* requirements. Thus, in the 1996 welfare reform, to be eligible for a grant, states would have to continue to spend at least 75 percent of the amount that they had previously spent.[17]
    a. Show what this does to the budget constraint of the community.
    b. How effective are such restrictions likely to be over time, as incomes grow?
    c. How might a state attempt to get around this requirement by reclassifying expenditures?
11. In the past, the federal government provided general revenue sharing. The argument for general revenue sharing was that the federal government was in a better position to collect tax revenues. States may, however, simply impose a tax that is based on the individual's federal income tax; that is, they could impose a tax that is, say, 20 percent of the federal tax payment. Provided that the federal government shares its information about where individuals live and what taxes they have paid, there would then be little incremental cost of tax collection, either to individuals or the state. Why might the federal government nonetheless be in a better position to collect tax revenues than the states?

[17] If a state fails to meet work participation rates, the spending level rises to 80 percent. (Source: House Committee on Ways and Means, *Overview of Entitlement Programs, 1996 Green Book*, p. 1333.)